



A Brief Tax Guide

for the
Independent
Music Teacher

MTNA

MUSIC TEACHERS NATIONAL ASSOCIATION

The answers to the questions posed in this publication are based on an understanding and interpretation of the Internal Revenue Code at the date of publication. However, the situations presented here are very general in nature, and the answers given are intended to give an overview of the rules and regulations involved. They should not be relied upon as the final authority in your particular situation. Consult your own tax and legal advisors regarding your own particular situation and circumstances. All Internal Revenue Service Publications may be obtained by visiting the IRS website at www.irs.gov.

This tax guide was first published in 1989 as an outgrowth of the work of the MTNA Independent Music Teachers Forum (IMTF). The IMTF was formed in 1973 to explore the problems, advantages and practices related to independent music teaching. Since its inception, the IMTF has contributed significantly to the establishment of the independent music teacher as a true professional.

The issue of taxes has been a pressing concern on the minds of most professional independent music teachers (IMTs). In fact, financial stability often hinges on the teacher's knowledge of the tax laws that impact their studios. Thus, it is vital the IMT know, understand and follow the Internal Revenue Code.

The questions found in this guide are the ones most frequently asked by IMTs. While the questions have remained constant over the years, the answers have not. Therefore, this new edition of MTNA's tax guide was necessary.

Certainly, many readers will have additional tax questions not covered in this guide. You should consult your personal tax advisor for the answers. However, you also are encouraged to send your questions to MTNA for possible inclusion in future editions of this guide.

We hope you find the information in this guide useful, as well as informative.

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FILING REQUIREMENTS AND RECORDKEEPING

Q. *As a performing musician and independent teacher, my income is divided between two professional areas. Should I file a separate Schedule C for each area, keeping records of income and expenses for each area?*

A. Since these are two separate activities, the income and expenses should be kept separate and reported on separate Schedule Cs with your income tax return. The reason for this is to make sure each activity is conducted for profit. If a business is presumed to be for profit, any deductions in excess of income for the year are deductible on the tax return. If the activity is not deemed to be for profit, net losses are considered “hobby losses” (discussed later) and not deductible on the tax return (see IRS Publication 535).

Q. *What records should I keep of income earned and expenses incurred in my teaching business?*

A. You should choose a system of recordkeeping that clearly reflects income from the business activity. Whether you use a manual ledger system or computerized software to assist in keeping the books of the business, good financial records will help the owner monitor the progress of the business and will aid in the preparation of accurate and complete financial statements and tax returns.

A separate checking account and credit card should be used for the business. While the business checkbook is the main source of financial transactions, documents supporting the transactions should be maintained in an organized manner. Examples of supporting documents that will provide substantiation in an IRS audit include invoices, receipts, deposit details, cancelled checks and paid bills. IRS Publication 583 includes information on record-keeping requirements.

Q. *If my expenses exceed my income during a given tax year, should I file a Schedule C?*

A. The IRS requires any income from a trade or business to be reported on your income tax return. If your expenses exceed your income for the year and the activity is not considered a hobby, you may deduct the net loss against any other income on your tax

return. Even if this is considered a hobby, the income should be reported. Any expenses up to that amount of income then can be deducted to reduce taxable income from this activity to zero.

Q.
A.

How long am I permitted to operate at a loss?

If you operate at a profit for three of the last five taxable years, you are deemed to have a for-profit business, and the current year net loss may be deducted against other income from your tax return. If you fail to meet this test, you still may be considered to operate for profit. All circumstances surrounding the business need to be examined in this case. Spending considerable time in the business, operating in a business-like manner, keeping adequate records, relying on expert advice to improve the business and relying on the business as your livelihood are some factors that determine profit motive. It is important to note that these factors are not all inclusive, and no one factor alone is decisive in determining the activity as a for-profit activity.

Failing to prove a profit motive will mean losses are considered “hobby losses.” In this case, you may deduct expenses only to the extent of income from the activity. You may not deduct expenses in excess of the income, even if you have a separate activity with net income.

Q.
A.

How do I determine the amount to pay for estimated taxes, and when are these payments due?

You may figure your estimated taxes based either on your prior year tax liability or your expected current year liability, depending on which is more beneficial to you. In either case, you must pay an adequate amount of estimated tax to avoid penalties for underpayment. If you wish to calculate the estimates based on the prior year, simply subtract your expected tax withholdings from the total tax on the prior year return. The difference is the estimated tax to pay for the year. Higher income taxpayers will need to multiply the prior year tax by 110 percent, then subtract the current year tax withholdings to determine the amount of the safe estimates.

If you accurately can determine your current year tax liability, you can base your estimates on this amount. Multiply the expected liability by 90 percent and subtract your current year tax withholding; the difference is the required estimated tax payment.

You also may use an annualized method to determine estimates. This may be preferable if most of your business

income occurs later in the tax year. Regardless of the method you choose, no estimated tax payment is required if you determine your estimated tax liability is less than \$1,000 or you expect to owe less than \$1,000 in tax after subtracting your withholding and credits.

You should pay 25 percent of your liability with each estimated tax installment. These installments are due April 15, June 15, September 15 of the current year and January 15 of the following year.

Q. *How is self-employment tax computed, and am I obligated to pay it?*

A. For the self-employed individual, the self-employment tax consists of a combination of Social Security tax (12.4 percent) and Medicare Insurance tax (2.9 percent). Check with the IRS to see how much of your earnings are subject to the Social Security tax. This amount increases each year due to inflation. If you have paid Social Security tax through payroll withholding during the year, you need to pay only the tax on \$113,700 less the amount on which you already have been taxed. Medicare Insurance tax applies to your entire Schedule C earnings. Self-employment tax is calculated on Schedule SE of the federal tax return and is paid with your income tax. No self-employment tax is due if Schedule C earnings are below \$400. A deduction of 50 percent of this tax is allowed in arriving at adjusted gross income on page 1 of Form 1040.

BUSINESS DEDUCTIONS

Q. *What expenses can I deduct for operating a studio in my home, and how do I determine the percentage of deduction I am able to take?*

A. If you have an area of your home used exclusively and on a regular basis for business and either a) it's your principal place of business or b) you meet with students in that location in the normal course of business, you may deduct certain expenses associated with your home. In addition, if students do not come to your home but you do perform administrative activities in the area used exclusively for business and you have no other fixed business location, you may qualify for the home office deduction.

If you qualify for the home office deduction, you must determine what percentage of your home is used for business. Divide the square footage of the area used for business by the total square footage of the house. This percentage is then multiplied by each type of indirect expense to determine the business deduction. Indirect expenses are costs that relate to the entire house such as real estate tax, insurance, mortgage interest, rent, utilities and depreciation.

Direct expenses are costs that relate directly to the area used for business. For example, the cost of repairs solely in the business area is a direct expense. Direct expenses are fully deductible and not reduced by the percentage of the home not used for business.

Your deduction for these expenses cannot exceed the net income derived from the business. Any expenses that aren't allowed may be carried forward to offset income in future years. IRS Publication 587 discusses business use of your home.

Q.

How do I deduct costs of business transportation? What must be included in my mileage log?

A.

Two methods—the actual method and the standard mileage rate method—are available for determining expenses for vehicle usage. The actual method is determined by dividing the business miles by the total mileage on each vehicle used. The resulting percentage is multiplied by the actual vehicle expenses such as gasoline, oil, repairs, insurance, leases, depreciation and so forth. This gives you the deductible portion of the vehicle expenses.

When computing the deduction under the standard mileage rate method, your business miles are multiplied by the standard mileage rate. Check www.irs.gov for the current rate; search the term “mileage.” When using this method, you cannot deduct any actual vehicle expenses.

When deducting vehicle expenses, you should maintain a mileage log with the following information for each vehicle:

- Date, business purpose and total miles for each business trip
- Actual vehicle expenses (if the actual method is used)
- Total mileage on the odometer at the beginning and end of each tax year

If you use the actual method in the first year a vehicle is in service, you may not use the standard mileage method for that vehicle in later years. You may switch from the standard mileage method to the actual method at any time.

Transportation expenses that don't relate to the vehicle or mileage, such as parking fees and tolls, cab fare, airplane tickets and so forth, are fully deductible. IRS Publication 463 gives advice on transportation expenses.

Q. *If I teach in several locations on a regular basis, how do I determine what mileage is deductible and what is not?*

A. If you qualify for the home office deduction, all business travel is deductible. If you do not qualify for the home office deduction, travel to your first business location of the day is not deductible. Any business travel after that point is deductible. However, the commute home after leaving the final work place is again non-deductible unless you qualify for the home office deduction.

Q. *What qualifies as business entertainment, and what records should I keep if I plan to deduct these costs?*

A. Business entertainment must be ordinary and necessary to your business to claim a deduction. The expense must be related directly to the active conduct of your trade or business or, if not directly related, immediately preceding or following a bona fide business discussion. The entertainment must have a clear purpose of benefiting the business in some way such as the continuation of an existing business relationship.

Business meals also are deductible only if there is a bona fide discussion of business at some point during or immediately before or after the meal. You should maintain a log showing the date, place, attendees and business reason for all meal and entertainment expenses, in addition to the receipt for documentation.

Generally, the tax deduction for meal and entertainment expenses is limited to 50 percent of the actual expenses provided the expenses are not lavish or extravagant. IRS Publication 463 gives further information on business meals and entertainment.

Q. *Can I deduct the cost of travel and accommodations to a professional conference held abroad?*

A. To deduct the entire amount of travel for conferences outside North America, the conference must be related directly to your business, and it must be as reasonable to hold the conference outside North America as it is in it.

If you meet these requirements, you also must meet the requirements for deducting business trips in general. Even if you spend some time in nonbusiness activities while away, the cost of the trip may be deductible if you meet one of the following exceptions:

- 1) You have no substantial control over planning the trip.
- 2) You are outside the United States no more than a week.
- 3) Less than 25 percent of the time was spent in personal activities.
- 4) Vacation was not a major consideration.

Q.

Can I deduct expenses for dues to professional societies and subscriptions to professional journals?

A.

Expenses are deductible for costs that are ordinary and necessary for the conduct of your business. Professional dues and subscriptions meeting these criteria therefore are deductible.

Q.

If I teach without pay for a qualified charitable organization, can I deduct the value of my services as a charitable contribution?

A.

Because you do not recognize fee income for volunteer work, you cannot deduct the value of these services. However, you may deduct, as a charitable contribution, your unreimbursed expenses for providing these services, such as mileage, telephone or any other related expenses.

Q.

Can I deduct any costs not directly related to my business?

A.

Self-employed individuals with a net profit reported on Schedule C or C-EZ can deduct 100 percent of the medical and dental insurance and long-term care insurance premiums paid as long as they are not eligible to participate in a subsidized employer-sponsored plan (including the spouse's employer). The deduction does not affect self-employment tax, but does reduce income tax. Insurance premiums for a policy that pays for lost earnings due to sickness or disability are not deductible; however, premiums paid for overhead insurance that pays for business overhead expenses incurred during long periods of disability caused by injury or sickness are deductible.

EQUIPMENT PURCHASES AND DEPRECIATION

Q. *What methods of depreciation are available, and how do I determine the method that provides the best tax advantage?*

A. In general, property is depreciated using the Modified Accelerated Cost Recovery System (MACRS). MACRS places property into certain classes with useful lives determined by the IRS. This system allows you to choose straight-line depreciation or accelerated depreciation for most assets. Accelerated depreciation allows you to take larger depreciation deductions in the early years of an asset's life while taking less deductions in later years.

Real estate is classified either as 27.5-year residential or 39-year nonresidential real property and can be depreciated only under the straight-line method. Publication 946, *How to Depreciate Property*, provides detailed information about depreciation.

Q. *Which studio purchases are deducted fully in the year of purchase, and which are depreciated?*

A. The cost of any asset with a useful life greater than one year must be capitalized. No current deduction is allowed for these assets. Instead, the cost is deducted through depreciation over the life of the asset. In addition, any improvements made to an asset, such as an addition on a house that will be used as a studio, must be capitalized. The useful life of selected assets is determined by IRS rules, as follows:

Computer hardware	5 years
Vehicles	5 years
Office furniture	7 years
Musical instruments	7 years
Residential real estate	27.5 years
Nonresidential real estate	39 years

Even if you must capitalize an asset, you may be eligible for Section 179 depreciation of up to \$500,000 for 2013. This allows you to deduct the cost of the new asset in the current year. However, several limitations exist before this deduction may be claimed. IRS Publication 946 provides additional guidance on useful lives and Section 179 expensing.

Q. *What is the best time of year to purchase a major piece of equipment for my studio?*

A. Generally, for property with a useful life of 20 years or less, all assets are treated as if they were purchased at the midpoint of the tax year. This is known as the half-year convention. However, if during the final three months of the tax year the cost of property placed in service exceeds 40 percent of the cost of all property placed in service during the entire year (without regard to property on which Section 179 was used), the mid-quarter convention must be used. The mid-quarter convention will usually result in a lower depreciation deduction in the first tax year. If you are utilizing the Section 179 deduction, the qualifying business asset must be purchased and placed in service in the current year without consideration of the month of the year in which it is purchased.

Q. *I wish to purchase a computer primarily for use in my studio and depreciate its cost. Must I use it only for my business?*

A. If you use a computer for both business and personal use, you must determine the time spent on the computer for each activity. You then can depreciate the business portion. Business use must exceed 50 percent in the year the computer is first placed in service to claim the first-year expensing deduction. If your business use is less than 50 percent, further limits will apply to the deduction. See Publication 946 for more information.

Q. *When purchasing a piece of equipment, does it matter whether it is new or used equipment?*

A. Any used asset purchased is subject to the MACRS depreciation system discussed earlier. It also is eligible to be used as Section 179 property if you meet the other requirements.

Q. *Can I depreciate my piano and cello on my taxes?*

A. Yes, instruments can be depreciated if used in a business activity. One thing to consider is the cost of the instrument; the IRS has set the line at \$500. If an instrument is less than \$500 it may be expensed; however, if it is over \$500 it needs to be depreciated over the useful life. There is a one-time expensing election (section 179) which allows the taxpayer to write the asset off in the year of purchase as long as there is sufficient taxable income in the business to allow for the section 179 deduction. You should speak with your tax preparer for more information.

OTHER ISSUES

Q. *Are there any advantages of hiring my spouse or children?*

A. If you pay a spouse or child a reasonable wage for legitimate business-related services, you may deduct these costs on your Schedule C. Wages paid to a spouse for working in your business are subject to FICA tax and income tax withholding; however, wages paid to a child are subject to income tax withholding but exempt from FICA tax if the child is under age 18.

Shifting income to the children could be beneficial if you are in a higher income tax bracket. The income could allow either the child or spouse to fund a retirement plan. In addition, certain employee benefits could be offered to a spouse/child that are deductible for your business but not taxable to the employee. (These would need to be offered to all employees.) Keep in mind you should only pay your family members market price for legitimate business services, and such income should be reported as income on his or her personal income tax return.

Employing family members may also enable you to take advantage if various employer benefit programs such as a medical expense reimbursement plan and simplified retirement plans that can save thousands of dollars in taxes.

Q. *What are the advantages and disadvantages of incorporating my business? Are there any other options?*

A. You have several options when deciding what form of business to use. There is no one answer because everyone's situation is different. Always consult with both tax and legal advisors before making this decision. A brief overview of the different types of entities follows, in no particular order:

- Sole proprietorship—This is the simplest form of business from an administrative standpoint. Your income and expenses are reported on Schedule C, and you pay income tax and self-employment tax on the net earnings of the business. The owner may draw funds from the business; however, such draws are not subject to withholding of tax. Quarterly estimated tax payments are necessary to meet the minimum withholding requirements as discussed earlier in this publication.
- Limited Liability Company (single-member)—This is a sole proprietorship with increased legal protection. You still report the income on Schedule C and pay income tax and self-em-

ployment tax on the earnings. If you have a partner in the LLC, you would be taxed as if you were a partnership (below).

- C Corporation—This entity is separate from its owners and pays its own tax. Any net income (after your salary) is taxed at corporate tax rates. This offers some flexibility in determining your salary based on your personal tax rate versus corporate tax rates. In addition, other fringe benefits may be available to you as an employee of the C Corporation. However, the paperwork for a corporation is more cumbersome than for a sole proprietorship. Any dividends you take from the corporation will be taxable to you even though the earnings were already taxed to the corporation, also known as double taxation.
- S Corporation—Legally, this is the same as a C Corporation. However, this entity is completely different for income tax purposes. The S Corporation files a separate tax return, with the net income being “passed through” to the shareholder’s income tax return. You do not pay self-employment tax on the net income. However, the IRS does require that you take a reasonable salary during the tax year. As with a C Corporation, the paperwork is more cumbersome than with a Schedule C.
- Partnership—If you have a partner in the business and have decided against incorporating, you will be considered a partnership. Like an S Corporation, your share of the partnership’s net income will “pass through” to your individual tax return. Unlike an S Corporation, you will pay self-employment tax on your share of the entire net income. While the administrative functions are less cumbersome than for a corporation, it still is more cumbersome than a sole proprietorship.
- While the paperwork requirements and associated professional fees for a C corporation or S corporation will be higher than for a schedule C, the tax savings achieved may make the choice cost effective.

Q.

My student’s parent has asked me for my Tax ID number for their taxes. Am I obligated to provide this to them?

A.

Ask for an explanation of why they need your Tax ID number. The client may be trying to take the dependent care credit, which would be aggressive if you are not providing child care services. If they are trying to issue you a Form 1099, you are required to provide them with your Tax ID number, which is accomplished on the W-9 Form.



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